AGENDA — October 24, 2001 Business Taxes Committee Meeting

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites, Regulation 1699, Permits

Action 1 — Consent Item(s) Adopt proposed amendments as agreed upon by interested parties and staff. Exhibit 2, Pages 1-2 & 4	(1) Add subdivision (h)(1) to define the term "buying company." (2) Add subdivision (i) to clarify that a seller's permit will generally not be issued to the location of a computer server.
Action 2 — Mark up Requirement – Subdivision (h)(2)(A) Exhibit 2, Page 2	Adopt either: 1) Staff's recommendation that a person "add a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses", or 2) Municipal Resource Consultant's proposal that a person "establish that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation and produce a reasonable profit margin," or 3) Arthur Andersen's proposal that a person "add a markup to its cost of goods sold and/or use an implicit interest rate on leases in an amount sufficient to cover its operating and overhead expenses on an annual basis."
Action 3 —Requirement that Transactions be Invoiced - Subdivision (h)(2)(B) Exhibit 2, Page 3	Adopt either: 1) Staff's recommendation that a person "issue an invoice to the customer, in paper or electronic form, to document the transaction," or 2) Ernst & Young's proposal that a person "invoice or otherwise account for the transaction," or 3) KPMG's proposal that a person "invoice or otherwise provide a transactional record of the transaction."

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Action 4 —Requirement that a Separate Identity be Maintained - Subdivision (h)(2)(C) Exhibit 2, Page 3	Adopt either: 1) Staff's recommendation that a person "maintain a separate identity with respect to the use of employees, accounting systems (including accounting for cash receipts and disbursements), facilities, and equipment," or 2) In response to concerns expressed by Deloitte & Touche, do not include this as a criteria used to establish the presumption that a buying company has not been formed for the purpose of redirecting local tax.
Action 5 —Municipal Purchasing Corporations - Subdivision (h)(3) Exhibit 2, Pages 3-4	Adopt either: 1) Staff's recommendation to not issue a seller's permit to a municipal purchasing corporation that purchases tangible personal property ex-tax exclusively to the municipality that created it or to which it is otherwise related, or 2) KPMG's recommendation to strike this paragraph in its entirety.
Action 6 — Approval to Publish	Recommend the publication of the proposed amendments to Regulation 1699, *Permits*, as adopted in the above actions. Operative Date: None Implementation: Implementation will take place 30 days following approval by the Office of Administrative Law.

AGENDA — October 24, 2001 Business Taxes Committee Meeting

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites, Regulation 1699, Permits

Action Item	Staff and Interested Parties Proposed Language
ACTION 1 **Consent Items** 1) Definition of the term "buying company."	**(h) BUYING COMPANIES - GENERAL.** (1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall not be issued a seller's permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. A buying company that is not formed for the purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases.
2) Clarification that a seller's permit will generally not be issued to the location of a computer server.	(i) **WEB SITES**. The location of a computer server on which a web site resides may not be issued a seller's permit for sales tax purposes except when the retailer has a proprietary interest in the server and the activities at that location otherwise qualify for a seller's permit under this regulation

AGENDA — October 24, 2001 Business Taxes Committee Meeting

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites, Regulation 1699, Permits

Action Item	Language Proposed by Staff	Language Proposed by Interested Parties	Language Proposed by Interested Parties
ACTION 2 – Mark up Requirement	(2) ELEMENTS. A buying company is formed for the purpose of re-directing local sales tax if it fails to: **(A)** Add a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.	(2) ELEMENTS. A buying company is formed for the purpose of re-directing local sales tax if it fails to: **(A)** Establish that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation and produce a reasonable profit margin.	(2) ELEMENTS. A buying company is formed for the purpose of re-directing local sales tax if it fails to: **(A)** Add a markup to its cost of goods sold and/or use an implicit interest rate on leases in an amount sufficient to cover its operating and overhead expenses on an annual basis.
ACTION 3 – Requirement to invoice transactions	**(B)** Issue an invoice to the customer, in paper or electronic form, to document the transaction.	**(B)** Invoice or otherwise account for the transaction.	**(B)** Invoice or otherwise provide a transactional record of the transaction.
ACTION 4 – Requirement that a separate identity be maintained	**(C)** Maintain a separate identity with respect to the use of employees, accounting systems (including accounting for cash receipts and disbursements), facilities, and equipment.		

AGENDA — October 24, 2001 Business Taxes Committee Meeting

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites, Regulation 1699, Permits

Action Item	Language Proposed by Staff	Language Proposed by Interested Parties	Language Proposed by Interested Parties
ACTION 5 – Municipal purchasing corporations	(3) MUNICIPAL PURCHASING CORPORATIONS. A buying company formed by, owned or controlled by, or otherwise legally related to, a city, city and county, county, or redevelopment agency, which purchases tangible personal property ex tax solely for resale to such city, city and county, county, or redevelopment agency, shall not be recognized as a separate legal entity from the related city, city and county, county, or redevelopment agency which created it for purposes of issuing the buying company a seller's permit. Such buying company shall not be issued a seller's permit. The tangible personal property purchased by a buying company from the vendor(s) shall be regarded as having been purchased from the vendor(s) directly by the city, city and county, county, or redevelopment agency related to the buying company		

Issue Paper Number 01 - 033

BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- ☐ Board Meeting
- ☒ Business Taxes Committee
- ☐ Customer Services and Administrative Efficiency Committee
- ☐ Legislative Committee
- ☐ Property Tax Committee
- ☐ Other

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites, Regulation 1699, Permits

I. Issue

Should Regulation 1699*, Permits,* be amended to clarify under what circumstances a seller's permit should be issued to buying companies and to sellers' websites?

II. Staff Recommendation

Adopt staff's proposed amendments to Regulation 1699, *Permits*, to clarify the circumstances under which a seller's permit should be issued to a "buying company" and a sellers' website. Staff's proposed amendments provide a definition of the term buying company and a means of identifying the circumstances under which a permit will not be issued. Staff's proposed language also provides clarification as to when a permit will not be issued to a municipal purchasing corporation.

The proposed regulation amendments have no operative date.

III. Other Alternative(s) Considered

Adopt staff's recommendation, except:

1. Amend staff's proposed subdivision (h)(2)(A) to read: "*Establish that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation and produce a reasonable profit margin*."

2. Amend staff's proposed subdivision (h)(2)(A) to read: "Add a markup to its cost of goods sold *and/or use an implicit interest rate on leases* in an amount sufficient to cover its operating and overhead expenses *on an annual basis*."

3. Amend staff's proposed subdivision (h)(2)(B) to read: "Invoice *or otherwise account for* the transaction."

4. Amend staff's proposed subdivision (h)(2)(B) to read: "Invoice *or otherwise provide a transactional record of* the transaction."

5. Delete staff's proposed subdivision (h)(2)(C), regarding the requirement to maintain a separate identity.

6. Delete subdivision (h)(3) regarding municipal purchasing corporations.

IV. Background

The California Sales and Use Tax Law imposes a sales tax upon retailers for the privilege of selling tangible personal property at retail in the State of California. The use tax is complementary (and mutually exclusive) to the sales tax and is imposed upon the consumer for the storage, use, or other consumption of tangible personal property in the State of California. Either the sales tax or the use tax applies to all retail sales of tangible personal property to customers in California, unless specifically exempted by statute.

Starting in 1945, cities began levying sales and uses tax separate from those imposed by the state. Under the locally imposed programs, retailers were required to file separate sales and use tax returns, sometimes at different rates of tax, for each city in which they were engaged in business. Cities adopted their own exemptions and conducted their own audits of retailers. Businesses that operated within cities that did not impose a local sales tax were viewed as having an unfair competitive advantage over those operating in cities imposing a tax. Counties were not allowed to impose local sales and use taxes.

In response to these concerns, the Bradley-Burns Uniform Local Sales and Use ("Local") Tax Law was enacted during the 1955 legislative session. Sections 7202 and 7203 of the Local Tax Law authorized counties to levy a one-percent sales and use tax that would be administered by the state. Under section 7202(g), the cities may levy a local tax at a rate of up to one percent to offset the county tax within their jurisdictions, thus maintaining the uniform rate. During the 1972 Legislative Session, the counties were allowed to raise their local tax rate to the current 1.25%. The extra one-quarter percent is dedicated to the counties to finance local transportation projects.

With a few exceptions, the exemptions and exclusions from the local sales and use taxes mirror those of the state sales and use tax. The one-and-one-quarter percent county tax applies uniformly throughout each county in the state, as each county levies this tax. The city taxes apply to sales within the city jurisdiction, and offset the county taxes to maintain a uniform rate. The county gets the 0.25 percent tax over and above the one percent tax on all sales within its borders. With respect to unincorporated areas of a county, the county retains the entire amount of the one-and-one-quarter percent local tax.

The Board administers the local tax pursuant to contracts entered into with each city, county, city and county, and redevelopment agency in accordance with section 7202. Taxes collected by the Board are allocated on a quarterly basis, less the Board's administrative costs imposed pursuant to section 7204.3. Limitations on redistributions made by the Board are imposed by section 7209. Under recently enacted section 6066.3, cities and counties may collect information from retailers within their jurisdictions for the purpose of determining if those retailers have seller's permits.

For the purpose of the following discussion, the term "cities" includes cities, counties, cities and counties, and redevelopment agencies unless otherwise specified. With the enactment of the Local Tax Law, cities were able to establish a source of revenue without the burden of establishing a system to administer the program. Existing cities were able to reduce the costs of administration for both their own city and the retailers located within their city. An additional benefit of the Local Tax Law was that the counties could impose a local sales and use tax. Retailers could file only one return to remit taxes to both the cities and the state. In addition, audits were conducted for both tax programs by one agency.

As the tax base was generally the same, it was easier for retailers to determine what was taxable and what was not for both the state and the cities. The local tax system also afforded merchants protection from untaxed competitors located in nearby cities. Cities supported the enactment of the Local Tax Law for these reasons as well as the cost savings derived from the use of the administrative and audit resources of the state. All counties and cities participate in this program. In fiscal year 1999-2000, approximately $4.1 billion in local tax revenues was returned to the state's 58 counties and 475 cities. In recent years, cities have become increasingly dependent upon local sales and use tax revenues to support their programs.

Because local taxes are locally enacted, the activities giving rise to local sales or use tax revenues must occur within the jurisdiction seeking to tax those activities. For example, regarding the local sales tax, the sales negotiations must take place in the city levying the local sales tax, regardless of where the title transfer takes place. Under the local tax system, the Board has always had inherent power to ensure that local tax is allocated to the jurisdiction in which those activities occurred. At first, however, there were no limitations on how far back the Board had to re-allocate the revenue. However, after returns reporting local taxes were submitted, there were several significant misallocations discovered. In some cases the necessary reallocations could have caused severe financial harm to the cities which would lose the local tax previously allocated to them. In response to this, in 1959 the Legislature enacted section 7209 with the Board's support, with the specific intent of limiting the impact of reallocations on the cities.

Issuing Permits to Buying Companies

In recent years, cities have become increasingly dependent upon local sales and use tax revenues to support their programs. In an effort to expand both the employment and tax base of their city, some city governments have provided financial incentives to businesses that establish "buying companies" within their jurisdictions. Absent the existence of a buying company, the local taxes are allocated according to the cities in which the vendors selling tangible personal property to the existing businesses are located. However, a central buying company purchases goods for resale and will allocate the local tax to the city in which the central buying company is located. This issue must be distinguished from the shift in local sales tax revenues, which occurs when a retailer moves its sales operations from one city to another. When a "buying company" (a term that has arisen over the years among cities dealing with this issue) is formed, the identity of the purchaser changes, not its location.

As noted above, local tax rates are the same statewide. As a result, the shifting of local tax revenues from one jurisdiction to another does not result in retailers paying any additional tax. Therefore, any additional revenue derived by one city will be at the expense of others.

A municipal purchasing corporation is a buying company that has been established by a municipality.

Issuing Permits to a Seller's Website

With the rise of the Internet, questions have arisen as to the allocation of local sales tax when a retailer takes an order by means of a website on the Internet and fulfills the orders from inventory already located in the state. Under long-standing case law, when orders are placed with a retailer that does not have an in-state sales location and the property is shipped from a stock of goods already located in the state by means of a distribution center belonging to the retailer, the applicable tax is the sales tax. Since there is no sales office involved when the order is placed though a website where the server on which the site resides is

located in California, Regulation 1802(a) does not address the allocation of local sales tax from such sales. Neither do the provisions of Regulation 1802(b)(5) strictly apply, as the orders are taken in state by means of the retailer's website.

A website is essentially an electronic forwarding agent, maintained on computers called "servers," from which orders are sent on to the retailer. Generally, orders are either forwarded automatically to the employees at the retailer's processing location or its employees electronically retrieve the orders from the website. Websites are generally maintained by independent third-party Internet Service Providers (ISPs) in which the retailer has no proprietary interest. The customer does not know the location of the server and, normally, neither does the retailer.

In 1997, the Board amended Regulation 1684 to provide that a website is not a place of business so as to give an out-of-state retailer nexus with California for use tax purposes. It is the position of the Board that similar principles apply with regard to sales tax. A website is generally not considered to be a place of business of the retailer (assuming that the retailer has no proprietary interest in the ISP). Annotation 701.0150, *Website vs. Warehouse*, states the following:

> An on-line retailer has no sales office in California. Its corporate headquarters, the computer server on which the retailer's website is located, and the warehouse from which orders are shipped are located in three different California cities. Customers place orders on the retailer's website. The orders are transmitted electronically to the warehouse, where the orders are processed and the goods are placed on the retailer's truck for delivery to the customers.
>
> A website is not a place of business for purposes of the local sales and use tax. Here, the retailer's employees first become involved in processing the orders at the warehouse. Accordingly, the warehouse is the place of sale for local sales tax purposes. The local sales tax is allocated to the place where the customer negotiates the sale with the retailer. 8/18/99. (2000–2).

Regulation 1684, *Collection of Use Tax by Retailers*, states that the use of a computer server on the Internet to create or maintain a World Wide Web page or site by an out-of-state retailer will not be considered a factor in determining whether the retailer has a substantial nexus in California. Just as the use of a website does not constitute nexus, staff is of the opinion that a website does not generally constitute a place of business for the purpose of issuing a seller's permit.

Meetings were held with interested parties on July 2, 2001 and on August 20, 2001. Representatives from various accounting and consulting firms as well as local governments were in attendance to discuss staff's proposed language. In response to concerns expressed at the meeting of interested parties held on August 20, 2001, staff amended the proposed language and provided it to all interested parties, including representatives of every city and county in California, on August 30, 2001.

V. Staff Recommendation

A. Description of the Staff Recommendation

Staff recommends the adoption of the proposed revisions to Regulation 1699, *Permits*, as illustrated in Exhibit 2. The proposed language regarding the issuance of a seller's permit to "buying companies" and to "seller's websites" has been added as subdivisions (h) and (i), respectively. The proposed changes have no operative date.

The Board is statutorily and contractually obligated to ensure that the cities in which sales occur receive their proper local tax revenues and to discourage activities designed to divert local tax from one city to another. The Board's policy has been to deny or revoke permits where it appears the activities are designed for the purpose of appropriating local tax revenues at the expense of other municipalities.

In order to ensure a uniform interpretation of the Revenue and Taxation Code, staff proposes language to add subdivision (h) to Regulation 1699, *Permits*, to clearly define the term "buying company" as a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity.

The language proposed by staff presumes that a buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. Such a buying company shall be regarded as the seller of tangible personal property it sells or leases, and is required to hold a permit. However, when a buying company is formed for the purpose of purchasing tangible personal property ex-tax for resale to the entity which owns, controls or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company, the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts. Under these circumstances, a buying company shall not be issued a seller's permit and sales to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. The Board will not redirect the allocation of local tax away from the location of the buying company and to the individual vendors when there is an operational need on the part of the establishing entity to support the existence of a buying company.

In addition to providing a definition of the term buying company, staff proposes language that identifies the circumstances under which a buying company is presumed to have been formed for the purpose of redirecting local sales tax. Staff proposes language that presumes that a buying company has been formed for the purpose of re-directing local sales tax if it fails to meet any of the following criteria:

- Adds a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.
- Issues an invoice to the customer, in paper or electronic form, to document the transaction.
- Maintains a separate identity with respect to the use of employees, accounting systems (including accounting for cash receipts and disbursements), facilities, and equipment.

During the course of the two meetings with interested parties, several interested parties questioned the Board's authority to adopt regulatory changes that would limit the issuance of seller's permits to buying companies. Staff is of the opinion that the Board has a legal and contractual obligation to ensure that the integrity of the Bradley-Burns Uniform Local Sales and Use Tax Law is maintained. Revenue and Taxation Code section 7051.1 gives the Board the statutory authority to allow a person, with prior approval by the Board, to purchase tangible personal property with a "direct payment permit" and to self report the sales tax. However, the statute specifically requires that the person allocate the local sales and use tax and any applicable district transactions and use tax to the municipality to which it would have been allocated if it had been reported and remitted by the retailers from whom the person purchased the property. Staff is of the opinion that a buying company is established to obtain many benefits that may be derived by use of a direct payment permit. The issuance of a direct payment permit is statutorily contingent upon the purchaser allocating the local and district taxes to the municipality that would have been the benefactor of those funds had the tax been collected and remitted by the retailer.

Issue – Buying Companies (General)

In response to the Second Discussion Paper and language that was distributed to all interested parties on August 30, 2001, staff has received twenty-eight submissions from interested parties regarding the subject of buying companies. Of the twenty-eight submissions, twenty-one support staff's position, and the remaining seven had concerns regarding the language proposed by staff.

The following parties expressed their support of the language proposed by staff: The League of California Cities, the Orange County Division of the League of California Cities, the cities of Beverly Hills, Los Angeles, Hawthorne, Irvine, Santa Ana, Tustin, Riverside, Santa Monica, Paramount, Fairfield, Palmdale, Richmond, Berkeley, Fresno, Rancho Santa Margarita, Santa Fe Springs, Westlake Village, San Luis Obispo and Sunnyvale.

The support expressed by these entities each contained similar language and concerns regarding the use of buying companies. The following excerpt from correspondence received from Ms. Lerma C. Tioseco of the City of Los Angeles, is representative of the letters received by all parties who have expressed their support for staff's position.

> The increased use of "buying corporations" as a tactic to shift and centralize substantial amounts of local revenues to one jurisdiction is inconsistent with the purpose and spirit, and possibly the letter, of the Bradley-Burns Uniform Local Sales and Use Tax Act. Therefore, we support efforts to discourage formation and recognition of tax-advantaged buying corporations.
>
> The rebate or other tax benefit often associated with this tactic also reduces the aggregate amount of revenue being received by all local jurisdictions, usually, for the benefit of only one such jurisdiction.
>
> When a "buying corporation" is formed, the jurisdiction in which it is to be located will often be requested to accept a tax rebate or credit of substantial magnitude that it cannot afford to deny, assuming that the transaction will still increase its aggregate local taxes. Thus, the tax benefit often constitutes a significant motivation for the transaction. Whether it outweighs any sound business reasons for the arrangement will be an issue

> that must be evaluated carefully based on all the facts. If, in such a case, the operational reasons for using a buying corporation are not sufficient alone to justify its formation, and if substantial revenues formerly received by other local jurisdictions have been shifted by the new transactional pattern, a classic case for revoking the resale permit would be presented.

Staff has received submissions from the following parties with concerns regarding staff's proposed language: The City of Fremont; Ernst & Young, LLP; KPMG, LLP; Arthur Andersen, LLP; City of Long Beach; Deloitte & Touche, LLP; and Municipal Resource Consultants.

In a letter dated August 30, 2001, the City of Fremont states, "The Board of Equalization should have reasonable standards to prevent fraud. However, the formation of procurement corporations as place of sale should be allowed as long as they satisfy legitimate business needs and they meet the same criteria as private corporations."

Staff agrees that buying companies should be allowed so long as they satisfy legitimate business needs. The language proposed by staff states that a permit will not be issued in cases where a buying company has been formed for the purpose of redirecting local tax revenues. Staff's language provides an explicit presumption that a buying company has been formed for legitimate business purposes. The language proposed by staff does not consider whether or not a buying company has a development agreement with a public jurisdiction as a factor in determining whether or a not a permit is to be issued.

In their letter dated September 14, 2001, Mr. Rick Richman and Ms. Karri Rozario, representing Deloitte & Touche, LLP, (Deloitte) states "It is inappropriate to seek to ignore the existence of entities with admitted business purposes that actively buy and sell property, and seek to deny them seller's permits. A buying company should be recognized as a separate legal entity as long as it is either formed for a valid business purpose or actually engages in business and maintains adequate books and records with respect to its transactions. The Sales and Use Tax Law does not require more."

Staff agrees that it is inappropriate to ignore the existence of entities with legitimate business purposes. However, in contrast to Deloitte's position, the courts have declared that when two separate legal entities have such identity of interest as to be separate in name only, the Board must regard them as one entity and disregard sales made between each other. In addition, staff believes that a buying company should be recognized as a separate legal entity when it is formed for a valid business purpose *and* it actually engages in business and maintains adequate books and records with respect to its transactions. Staff is of the opinion that these two elements are interdependent and not mutually exclusive.

Issue – Markup Requirement

In a letter dated September 13, 2001, Mr. Glenn Bystrom, representing Ernst & Young, expresses concern regarding staff's previously proposed language that required, under subdivision (h)(2)(A), that a markup be added to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses *consistent with industry standards*. This phrase was intended to emphasize that no across-the-board markup was required but one that was consistent with the practices of vendors in the particular industry affected. For example, a buying company for an electric utility should use the same markup practices as the vendors to the utility which it is intended to replace. In response to concerns expressed by Ernst &

Young and others, however, that this phrase is ambiguous and confusing, staff has stricken "consistent with industry standards."

Deloitte & Touche states that staff's proposed language in subdivision (h)(2)(A) that requires a "markup be added to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses" is not required under Sales and Use Tax Law.

In his letter dated September 13, 2001, Mr. Rex Halverson, representing KPMG, expresses the following concern with staff's language.

> The requirement of a markup remains particularly troubling because it implies that a company must charge an affiliate more for goods than it actually paid for those goods and collect sales tax on that higher gross receipts amount. The only winner in such cases are state and local tax coffers. That is, the requirement to recover "operating and overhead expenses," alone, will actually increase the amount of tax a business will pay in California.

Staff does not agree with KPMG's statement that requiring a business to achieve a markup sufficient to merely recover its operating and overhead expenses will increase the amount of tax paid by California businesses. In fact, staff is of the opinion that businesses will pay less tax as the economies of scale derived by the purchasing company would offset the operating and overhead expenses incurred by the buying company. If this were not true, there would be no financial advantage to establishing a buying company. In addition, staff does not believe that businesses can sustain overall marginal losses on sales without the artificial support of another entity. When a buying company makes sales exclusively to a related legal entity at a marginal loss and then is financially supported by that entity, staff does not agree that an arm's length transaction has occurred.

In a letter dated September 13, 2001, Mr. Albin C. Koch, representing Municipal Resource Consultants (MRC), states that the requirements as proposed by staff are not sufficient to deter utilization of buying companies which are formed for the purpose of redirecting local taxes. Specifically, MRC contends that the markup proposed by staff in subdivision (h)(2)(A) is not a meaningful requirement for validating that the entity has an actual business purpose, since a markup on an inter company transaction does not represent profit, as the ultimate ownership is the same.

MRC proposes that the requirement that a sufficient markup to cover operating expenses and overhead in staff's proposed subdivision (h)(2)(A) be replaced with the following language: "Establish that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation and produce a reasonable profit margin."

Staff is of the opinion that the proposed language re-introduces the difficulty of defining a "reasonable profit margin" inherent in staff's original language. In addition, the requirement that a buying company achieve business advantages sufficient to cover the costs of creating and operating the entity is irrelevant as it can be reasonably assumed that an entity will not form a buying company unless such advantages can be derived. This is especially true when price discounts and "other business advantages" are used to compute the profitability of the buying company.

Issue – Use of Invoice

In its September 13, 2001 letter, Ernst & Young proposes that the second element in staff's proposed subdivision (h)(2)(B) be amended to state (as noted in italics) "Invoice *or otherwise account for* the transaction."

Mr. Lasher, representing Arthur Andersen, is of the opinion that "there are other methods of accounting for transactions other than invoicing which should suffice for sales tax purposes, for instance, a monthly statement with references to individual items sold." For this reason, Arthur Andersen concurs with the language proposed by Ernst & Young. Deloitte & Touche proposed identical language as well.

KPMG proposes that the language regarding the second element in staff's proposed subdivision (h)(2)(B) be amended to state (as noted in italics) "Invoice *or otherwise provide a transactional record of* the transaction." During our meeting of interested parties held on August 20, 2001, Mr. Halverson, of KPMG, expressed his concern that staff was requiring that paper records be transferred and maintained.

In a letter dated September 13, 2001, Mr. Robert E. Cendejas, representing the City of Long Beach, has suggested that the language proposed by staff in subdivision (h)(2)(B) "be broadened to include monthly or quarterly inter company accounting charges and credits between related companies or true-ups."

In response to the concerns expressed by industry representatives, staff has proposed a change to the previously proposed language (as noted in italics) to read as follows: "*Issue an* invoice *to the customer, in paper or electronic form, to document* the transaction." While the language proposed by staff clarifies that electronic invoices are acceptable, the language does require that a form of documentary evidence be maintained as is customary in transactions between two truly separate entities.

Staff had contacted representatives of Ernst & Young and Deloitte & Touche. Both feel that the amended language as presented by staff does not adequately address their concerns.

Issue – Leases

KPMG states in their September 13, 2001 letter that "in typical true leases no markup is the standard industry practice as a lessor is paid interest and is entitled to take a depreciation deduction on his or her income tax returns. A lessor's profit is based on these two elements plus any applicable tax credits, as well as, on the lessor's expertise of the resale market for used equipment when leased equipment comes off lease. Accordingly, due consideration should be given to addressing these leasing industry issues herein."

While the language proposed by staff does not directly address the issue of markups on leases, the factors mentioned by KPMG are included within the definition of gross receipts which are recovered in the form of the lease payment. The interest rate is essentially the markup, which is subject to tax in cases where a lease is a continuing sale, as is the scenario described by KPMG. Staff does not believe that language is necessary to differentiate between a "sale" and a "lease" since a lease, in this case, is a "continuing sale."

In their letter dated September 13, 2001, Arthur Andersen states, similarly to KPMG, that a markup of leased property is not commonly used and that "leasing companies ordinarily generate receipts from the implicit interest rate of the lease and/or the residual value of the leased property." Arthur Andersen specifically proposes that the following language be added to subdivision (h)(2)(A), as noted in italics:

"Add a markup to its cost of goods sold *and/or use an implicit interest rate on leases* in an amount sufficient to cover its operating and overhead expenses *on an annual basis*."

With respect to adding "and/or use an implicit interest rate" to the language proposed by staff, staff is of the opinion that the addition of "and/or" creates ambiguity. Staff is of the opinion that the term "implicit interest rate" is also ambiguous. In addition, the interest rate is merely one factor that must be weighed in order to determine whether there has in fact been a profit derived that is sufficient to cover operating and overhead expenses. While there may be an interest rate that appears to be more than sufficient, the residual value of the property leased is a crucial element in the formula of profitability.

Staff is of the opinion that Arthur Andersen's suggestion to quantify that the markup should be evaluated on an annual basis is not necessary and perhaps too restrictive. While staff does not agree with reviewing the markup percentages achieved on a transaction by transaction basis, staff feels that an annual review may not be appropriate. Rather, the overall markup percentages achieved may be best reviewed over a period of several years or perhaps the life of the entity in question. It is not staff's intention to review markups on an annual basis and revoke permits for some years and not others.

Issue – Separate Identity

In the position paper provided by Deloitte & Touche, concerns have been raised regarding the language proposed by staff in subdivision (h)(2)(C) that a separate identity be maintained with respect to the use of employees, accounting systems, facilities, and equipment. Deloitte & Touche contends that staff has not adequately defined the meaning of the term "separate identity." Deloitte & Touche notes that it is common for affiliated groups to have shared employees, centralized accounting systems, inter-company leases or other sharing arrangements with respect to facilities or equipment and that staff should not prescribe how a company structures its use of such assets.

Staff does not propose to prescribe how a company structures the use of its resources. However, the courts have found that the interdependence of resources between a purported "buyer" and "seller" are relevant factors in determining whether a true arm's length transaction has occurred.

Issue – Grandfather Clause

MRC also recommends that a grandfather clause be included in the proposed regulatory language in order to protect existing companies already in operation that were "created under present policies." This recommendation is consistent with many submissions received by local governments.

The proposed regulatory changes with respect to buying companies do not reflect a change in policy, but rather are an attempt to develop a means of quantifying existing policies. In addition, the proposed changes by staff are declaratory of existing law and are not the result of any statutory change. For these reasons, staff does not agree that a grandfather clause is appropriate.

Issue – Municipal Purchasing Corporations

Staff received submissions from the following interested parties regarding the proposed language on the issuance of a seller's permit to a municipal purchasing corporation: KPMG, and the cities of Beverly

Hills, Los Angeles, Long Beach, Tustin, Santa Monica, Fairfield, Palmdale, Richmond, Berkeley, Rancho Santa Margarita, Santa Fe Springs, Westlake Village, San Luis Obispo, Fremont and Sunnyvale.

Each of these submissions expressed concern that staff is creating a different standard for issuing permits to buying companies than to municipal purchasing corporations. The following excerpt from a letter received from the City of Richmond is representative of the comments received by staff regarding this topic:

> We also believe that it would be inequitable, however, to make a special case of "buying corporations" that might be established by one or more public agencies. If such a venture formed by a business group could pass muster under the proposed regulation, there would seem to be no fair justification for invalidating a similar arrangement that produces government efficiencies of scale, purchasing power or expertise. Furthermore, we are not aware that the formation of governmental entities of this nature that might conform to the proposed regulation is a substantial current problem.

In its letter dated September 13, 2001, KPMG suggests that the paragraph regarding municipal purchasing corporations be "stricken in its entirety," as there is "no basis in the law for discriminating against municipalities."

Staff does not agree that the language provided discriminates against municipalities. Furthermore, the state constitution prohibits a general law city or county from being a stockholder in any corporation (except for specified irrigation districts) (Cal.Const. Article 16 §6).

The language proposed by staff defines a buying company as "a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity." While a buying company will be presumed to have been formed for the purpose of redirecting local tax if it fails to meet the three criteria established in the proposed regulatory language, a municipal purchasing corporation will not be issued a seller's permit when it makes sales *solely* to the municipality which created it or to which it is otherwise related.

Staff proposes language to treat municipal purchasing corporations differently because they are a different type of legal entity. While a corporation is formed for the purpose of engaging in commerce with the intention of deriving a profit, a municipality is formed under the state constitution and the Government Code to serve the common good of the public. Such retailing operations in which municipalities engage are generally for the purpose of recovering the cost of the particular property sold. For example, when a municipality sells land plats, the selling price recovers the cost to the municipality of producing the plats.

The City of Long Beach states that the language proposed by staff "unfairly requires that a city owned buying company must meet the same requirements as a business plus sell to at least one other entity other than its parent." Staff apologizes for any misunderstanding regarding this issue. As previously stated, municipalities are not required to meet both the elements prescribed in subdivision (h)(2) and sell to at least one other entity.

Long Beach has inferred from the proposed language that, since a typical city government consists of several separate entities, and the buying company normally will be making sales to two or more of them, that the "additional" requirement will have been met by cities.

The language proposed by staff in subdivision (h)(3) provides, in part, that "a buying company formed by, owned or controlled by, *or otherwise legally related to*, a city, city and county, county, or redevelopment agency, which purchases tangible personal property ex tax solely for resale to such city, city and county, county, or redevelopment agency, shall not be recognized as a separate legal entity from the related city, city and county, county, or redevelopment agency which created it for purposes of issuing the buying company a seller's permit." In response to the concerns expressed by Long Beach, staff is of the opinion that a buying company formed by a municipality which makes sales to two other entities owned by the municipality will not qualify for a permit in cases where the entities are related.

Staff believes that a permit should not be issued to municipal purchasing corporations which are formed for the purpose of purchasing tangible personal property ex-tax for resale to the municipality which formed, owns, controls or is otherwise related to the municipal purchasing corporation.

In order to implement in regulatory form Board direction of long standing, staff proposes language that would create standards for municipal purchasing corporations that differ from other buying companies because they are unique. Municipal purchasing corporations cannot be purported to achieve a true "profit" in cases where it sells exclusively to the municipality which formed it or other entities created by the municipality. The Board was of the opinion that municipalities could achieve the economies of scale sought utilizing centralized procurement, which does not necessarily require a seller's permit, without incurring the conflict inherent with redirecting the local tax to their own municipality.

Local taxing jurisdictions are permitted to obtain direct payment permits for purchases subject to use tax. The direct payment permits allow a municipality to issue an exemption certificate for purchases subject to use tax and report the tax directly to the Board, allocating the local tax to the jurisdiction of use. Therefore, the only benefit derived from a municipal purchasing corporation holding a permit would be to issue a resale certificate for a purchase subject to sales tax.

Issue – Issuing Permits to a Seller's Website

Staff proposes that regulatory language be adopted to clarify that a seller's permit will not be issued to the location of a computer server on which a web site resides except when the retailer has a proprietary interest in the server and the activities at that location otherwise qualify for a seller's permit. Staff received submissions from the following interested parties concerning staff's proposed language regarding the issuance of a seller's permit to a website: the cities of Hawthorne, Santa Ana, Beverly Hills, Los Angeles, Tustin, Santa Monica, Palmdale, Richmond, Berkeley, Rancho Santa Margarita, Santa Fe Springs, Westlake Village and San Luis Obispo. Each of these cities expressed its support for staff's proposed language.

B. Pros of the Staff Recommendation

- Provides a definition of the term "buying company."
- Provides a clear and quantifiable means to apply the provisions of the Revenue and Taxation Code to buying companies and municipal purchasing corporations.
- Provides clarification that a website is generally not a location for which a seller's permit is to be issued.

C. Cons of the Staff Recommendation

None.

D. Statutory or Regulatory Change

Regulatory change is required.

E. Administrative Impact

Requires notification to Board staff.

F. Fiscal Impact

1. Cost Impact

No additional cost. Staff will notify taxpayers of the regulation amendments through a Tax Information Bulletin (TIB) article. The workload associated with publishing and distributing the TIB is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Provides clear guidelines for when the issuance of a seller's permit is appropriate, thus eliminating uncertainty for businesses contemplating establishing a buying company.

H. Critical Time Frames

No operative date is recommended.

VI. Alternative 1

A. Description of the Alternative

MRC proposes adopting staff's recommendation, except replacing subdivision (h)(2)(A) to read as follows: "*Establish that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation and produce a reasonable profit margin*." MRC contends that the markup proposed by staff in subdivision (h)(2)(A) is not a meaningful requirement for validating that the entity has an actual business purpose, since a markup on an inter company transaction does not represent profit, as the ultimate ownership is the same.

B. Pros of the Alternative

Considers the ultimate ownership of the related entities in determining whether profit was achieved.

C. Cons of the Alternative

- Creates the difficulty of defining a "reasonable" profit margin.
- Does not define the limits of other business advantages.
- The requirement that a buying company achieve business advantages sufficient to cover the costs of creating and operating the entity is irrelevant as it can be reasonably assumed that an entity will not form a buying company unless such advantages can be derived.

D. Statutory or Regulatory Change

Regulatory change is required.

E. Administrative Impact

Requires notification to Board staff.

F. Fiscal Impact

1. Cost Impact

No additional cost. Staff will notify taxpayers of the regulation amendments through a Tax Information Bulletin (TIB) article. The workload associated with publishing and distributing the TIB is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

The proposed alternative may create difficulty in administering the regulation uniformly, as there are no uniform means of quantifying business advantages.

H. Critical Time Frames

No operative date is proposed.

VII. Alternative 2

A. Description of the Alternative

Arthur Andersen proposes adopting staff's recommendation, except amending subdivision (h)(2)(A) (as noted in italics) to read as follows: "Add a markup to its cost of goods sold *and/or use an implicit interest rate* on leases in an amount sufficient to cover its operating and overhead expenses *on an annual basis*." This proposal is intended to clarify the requirement that profit be derived on leases and that transactions should not be viewed individually to ascertain whether a sufficient markup has been achieved.

B. Pros of the Alternative

- Clarifies that there must be a markup on lease transactions.
- Quantifies a period of time for which a sufficient markup must be derived.

C. Cons of the Alternative

- Does not provide a definition of the term "explicit interest rate."
- Does not address other factors that must be included in determining whether a sufficient markup has been derived from lease receipts.
- The requirement that the markup achieved be reviewed on an annual basis is too restrictive.
- Other than interest rate, does not address factors used to determine profitability on leases.

D. Statutory or Regulatory Change

Regulatory change is required.

E. Administrative Impact

Requires notification to Board staff.

F. Fiscal Impact

1. Cost Impact

No additional cost. Staff will notify taxpayers of the regulation amendments through a Tax Information Bulletin (TIB) article. The workload associated with publishing and distributing the TIB is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Provides some guidance with respect to leases, though not complete.

H. Critical Time Frames

No operative date is proposed.

VIII. Alternative 3

A. Description of the Alternative

Ernst & Young, Arthur Andersen and Deloitte & Touche propose adopting staff's recommendation, except amending subdivision (h)(2)(B) (as noted in italics) to read as follows: "Invoice *or otherwise account for* the transaction." This alternative would not require that an invoice be issued and allows an unlimited number of alternative methods of accounting for a transaction.

B. Pros of the Alternative

- Allows more alternatives with respect to documenting a transaction.

C. Cons of the Alternative

- Does not require that an adequate audit trail be maintained.
- Creates ambiguity with respect to what constitutes accounting for a transaction.

D. Statutory or Regulatory Change

Regulatory change is required.

E. Administrative Impact

Requires notification to Board staff.

F. Fiscal Impact

1. Cost Impact

No additional cost. Staff will notify taxpayers of the regulation amendments through a Tax Information Bulletin (TIB) article. The workload associated with publishing and distributing the TIB is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Ambiguity of the proposed alternative may make compliance more difficult.

H. Critical Time Frames

No operative date is proposed.

IX. Alternative 4

A. Description of the Alternative

KPMG proposes adopting staff's recommendation, except amending subdivision (h)(2)(B) (as noted in italics) to read as follows: "Invoice *or otherwise provide a transactional record of* the transaction." This alternative would not require that an invoice be issued and allows an unlimited number of alternative methods of accounting for a transaction.

B. Pros of the Alternative

Allows more alternatives with respect to documenting a transaction.

C. Cons of the Alternative

- Does not require that an adequate audit trail be maintained.
- Creates ambiguity with respect to what constitutes accounting for a transaction.

D. Statutory or Regulatory Change

Regulatory change is required.

E. Administrative Impact

Requires notification to Board staff.

F. Fiscal Impact

1. Cost Impact

No additional cost. Staff will notify taxpayers of the regulation amendments through a Tax Information Bulletin (TIB) article. The workload associated with publishing and distributing the TIB is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Ambiguity of the proposed alternative may make compliance more difficult.

H. Critical Time Frames

No operative date is proposed.

X. Alternative 5

A. Description of the Alternative

Deloitte & Touche proposes adopting staff's recommendation, except deleting the requirement in subdivision (h)(2)(C) that a person maintain a separate identity with respect to the use of employees, accounting systems (including accounting for cash receipts and disbursements), facilities, and equipment.

B. Pros of the Alternative

- Does not require that a permit holder maintain a separate identity to obtain a seller's permit.

C. Cons of the Alternative

- Allows permits to be issued to entities that are separate in name only.
- Does not provide meaningful requirements to deter the redirection of local tax.

D. Statutory or Regulatory Change

Regulatory change is not required.

E. Administrative Impact

None.

F. Fiscal Impact

1. Cost Impact

No additional cost. Staff will notify taxpayers of the regulation amendments through a Tax Information Bulletin (TIB) article. The workload associated with publishing and distributing the TIB is considered routine and any corresponding cost would be within the Board's existing budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Makes it easier for taxpayers to support that they are entitled to a seller's permit.

H. Critical Time Frames

No operative date is proposed.

XI. Alternative 6

A. Description of the Alternative

KPMG proposes adopting staff's recommendation, except deleting subdivision (h)(3), *Municipal Purchasing Corporations*. KPMG contends that there is no legal basis for "discriminating" against municipal purchasing corporations. A number of municipalities expressed general concerns regarding the different standards imposed upon municipal purchasing corporations.

B. Pros of the Alternative

Creates uniform guidelines for buying companies and municipal purchasing corporations.

C. Cons of the Alternative

Does not address the differences between buying companies and municipal purchasing corporations.

D. Statutory or Regulatory Change

Regulatory change is required.

E. Administrative Impact

Requires notification to Board staff.

F. Fiscal Impact

1. Cost Impact

No additional cost. Staff will notify taxpayers of the regulation amendments through a Tax Information Bulletin (TIB) article. The workload associated with publishing and distributing the TIB is considered routine and any corresponding cost would be within the Board's existing budgeted budget.

2. Revenue Impact

None. See Revenue Estimate (Exhibit 1).

G. Taxpayer/Customer Impact

Uniform guidelines may make compliance easier.

H. Critical Time Frames

No operative date is proposed.

Prepared by: Program Planning Division, Sales and Use Tax Department

Current as of: October 12, 2001

BOARD OF EQUALIZATION
REVENUE ESTIMATE

PROPOSED REGULATORY CHANGES REGARDING THE ISSUANCE OF A SELLER'S PERMIT TO "BUYING COMPANIES" AND TO SELLERS' WEBSITES, REGULATION 1699, *PERMITS*

Staff Recommendation

Adopt staff's proposed amendments to Regulation 1699, *Permits*, to clarify the circumstances under which a seller's permit should be issued to a "buying company" and a sellers' website. Staff's proposed amendments provide a definition of the term buying company and a means of identifying the circumstances under which a permit will not be issued. Staff's proposed language also provides clarification as to when a permit will not be issued to municipal purchasing corporations and a seller's website.

The proposed regulation amendments have no operative date.

Alternatives

Adopt staff's recommendation, except:

1. Amend staff's proposed subdivision (h)(2)(A) to read: "*Establish that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation and produce a reasonable profit margin*."

2. Amend staff's proposed subdivision (h)(2)(A) to read: "Add a markup to its cost of goods sold *and/or use an implicit interest rate on leases* in an amount sufficient to cover its operating and overhead expenses *on an annual basis*."

3. Amend staff's proposed subdivision (h)(2)(B) to read: "Invoice *or otherwise account for* the transaction."

4. Amend staff's proposed subdivision (h)(2)(B) to read: "Invoice *or otherwise provide a transactional record of* the transaction."

5. Delete staff's proposed subdivision (h)(2)(C), regarding the requirement to maintain a separate identity.

6. Delete subdivision (h)(3) regarding municipal purchasing corporations.

Background, Methodology, and Assumptions

Staff Recommendation:

There is nothing in the proposed amendments to Regulation 1699 that would impact revenues.

Alternatives:

The alternative proposals have no revenue impact.

Revenue Summary

The staff recommendation has no revenue effect.

The alternative proposals have no revenue effect.

Preparation

This revenue estimate was prepared by David E. Hayes, Research and Statistics Section, Agency Planning and Research Division. This revenue estimate was reviewed by Ms. Laurie Frost, Chief, Agency Planning and Research Division and Ms. Charlotte Paliani, Program Planning Manager, Sales and Use Tax Department. For additional information, please contact Mr. Hayes at (916) 445-0840.

Current as of October 9, 2001

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites

Comparison of Current and Proposed Language

Current as of October 12, 2001

Action Item	Regulatory Language Proposed by Staff	Regulatory Language Proposed by Interested Party 1	Regulatory Language Proposed by Interested Party 2	Summary Comments
ACTION 1 Consent Items 1) Definition of the term "buying company" in subdivision (h)(1).	**REGULATION 1699, PERMITS.** **(h) BUYING COMPANIES - GENERAL.** (1) DEFINITION. For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall not be issued a			Staff and industry are in agreement with the proposed definition of the term "buying company."

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites

Comparison of Current and Proposed Language

Current as of October 12, 2001

Action Item	Regulatory Language Proposed by Staff	Regulatory Language Proposed by Interested Party 1	Regulatory Language Proposed by Interested Party 2	Summary Comments
ACTION 2 – Mark up requirement in subdivision (h)(2)(A)	seller's permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. A buying company that is not formed for the purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases. (2) ELEMENTS. A buying company is formed for the purpose of re-directing local sales tax if it fails to: **(A)** Add a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.	(2) ELEMENTS. A buying company is formed for the purpose of re-directing local sales tax if it fails to: **(A)** Establish that the additional price discounts and other business advantages to be achieved by its operations are sufficient in themselves to cover the total costs of its creation and operation and produce a reasonable profit margin.	(2) ELEMENTS. A buying company is formed for the purpose of re-directing local sales tax if it fails to: **(A)** Add a markup to its cost of goods sold and/or use an implicit interest rate on leases in an amount sufficient to cover its operating and overhead expenses on an annual basis.	Interested party alternative 1 has been proposed by Municipal Resource Consultants and is intended to ensure that other financial incentives are included in determining whether a reasonable profit margin has been achieved. Interested party alternative 2 has been proposed by Arthur Andersen and is intended to account for leasing transactions and to clarify that profit margins are to be determined on an annual basis.

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites

Comparison of Current and Proposed Language

Current as of October 12, 2001

Action Item	Regulatory Language Proposed by Staff	Regulatory Language Proposed by Interested Party 1	Regulatory Language Proposed by Interested Party 2	Summary Comments
ACTION 3 – Requirement that transactions be invoiced in subdivision (h)(2)(B)	**(B)** Issue an invoice to the customer, in paper or electronic form, to document the transaction.	**(B)** Invoice or otherwise account for the transaction.	**(B)** Invoice or otherwise provide a transactional record of the transaction.	In concurrence with several other interested parties, alternative 1 was proposed by Ernst & Young. Alternative 2 was proposed by KPMG. Both interested party alternatives appear to achieve the same result.
ACTION 4 – Requirement that a separate identity be maintained in subdivision (h)(2)(C)	**(C)** Maintain a separate identity with respect to the use of employees, accounting systems (including accounting for cash receipts and disbursements), facilities, and equipment.			While no specific alternatives have been proposed, representatives of local governments and Deloitte have expressed concern over staff including this as a required element.
ACTION 5 – Municipal purchasing corporations in subdivision (h)(3).	(3) MUNICIPAL PURCHASING CORPORATIONS. A buying company formed by, owned or controlled by, or otherwise legally related to, a city, city and county, county, or redevelopment agency, which purchases tangible personal property ex tax solely for resale to such city, city and county, county, or redevelopment agency, shall not be recognized as a separate legal entity from the related city, city and			KPMG has proposed that staff's language be stricken in its entirety. Representatives of local governments have expressed their concern regarding staff's proposal, but have not offered alternative language.

Proposed Regulatory Changes Regarding the Issuance of a Seller's Permit to "Buying Companies" and to Sellers' Websites

Comparison of Current and Proposed Language

Current as of October 12, 2001

Action Item	Regulatory Language Proposed by Staff	Regulatory Language Proposed by Interested Party 1	Regulatory Language Proposed by Interested Party 2	Summary Comments
	county, county, or redevelopment agency which created it for purposes of issuing the buying company a seller's permit. Such buying company shall not be issued a seller's permit. The tangible personal property purchased by a buying company from the vendor(s) shall be regarded as having been purchased from the vendor(s) directly by the city, city and county, county, or redevelopment agency related to the buying company.			
ACTION 1 Consent Items 2) Clarification that a seller's permit will generally not be issued to the location of a computer server in subdivision (i)	**(i) WEB SITES**. The location of a computer server on which a web site resides may not be issued a seller's permit for sales tax purposes except when the retailer has a proprietary interest in the server and the activities at that location otherwise qualify for a seller's permit under this regulation			Staff and industry agree on the proposed language.

Regulation 1699. PERMITS

References: Sections 6066-6075, Revenue and Taxation Code.

(a) IN GENERAL –NUMBER OF PERMITS REQUIRED. Every person engaged in the business of selling (or leasing under a lease defined as a sale in Revenue and Taxation Code section 6006(g)) tangible personal property of a kind the gross receipts from the retail sale of which are required to be included in the measure of the sales tax, and only a person actively so engaged, is required to hold a permit for each place of business in this state at which transactions relating to sales are customarily negotiated with his or her customers. For example:

> A permit is required for a branch sales office at which orders are customarily taken and contracts negotiated, whether or not merchandise is stocked there.

No additional permits are required for warehouses or other places at which merchandise is merely stored and which customers do not customarily visit for the purpose of making purchases and which are maintained in conjunction with a place of business for which a permit is held; but at least one permit must be held by every person maintaining stocks of merchandise in this state for sale.

If two or more activities are conducted by the same person on the same premises, even though in different buildings, only one permit is required. For example:

> A service station operator having a restaurant in addition to the station on the same premises requires only one permit for both activities.

(b) PERSONS SELLING IN INTERSTATE COMMERCE OR TO UNITED STATES GOVERNMENT. A permit is not required to be held by persons all of whose sales are made exclusively in interstate or foreign commerce but a permit is required of persons notwithstanding all their sales (or leases under a lease defined as a sale in Revenue and Taxation Code section 6006(g)) are made to the United States or instrumentalities thereof.

(c) PERSONS SELLING FEED. Effective April 1, 1996, a permit is not required to be held by persons whose sales consist entirely of sales of feed for any form of animal life of a kind the products of which ordinarily constitute food for human consumption (food animals), or for any form of animal life not of such a kind (nonfood animals) which are being held for sale in the regular course of business, provided no other retail sales of tangible personal property are made.

If a seller of hay is also the grower of the hay, this exemption shall apply only if either:

1. The hay is produced for sale only to beef cattle feedlots or dairies, or

2. The hay is sold exclusively through a farmer-owned cooperative.

(d) CONCESSIONAIRES. For the purposes of this regulation, the term concessionaire is defined as an independent retailer who is authorized, through contract with, or permission of,

another retail business enterprise (the prime retailer), to operate within the perimeter of the prime retailer's own retail business premises, which to all intents and purposes appear to be wholly under the control of that prime retailer, and to make retail sales that to the general public might reasonably be believed to be the transactions of the prime retailer. Some indicators that a retailer is *not* operating as a concessionaire are that he or she:

- Appears to the public to be a business separate and autonomous from the prime retailer. Examples of businesses that may appear to be separate and autonomous, while operating within the prime retailer's premises, are those with signs posted on the premises naming each of such businesses, those with separate cash registers, and those with their own receipts or invoices printed with their business name.
- Maintains separate business records, particularly with respect to sales.
- Establishes his or her own selling prices.
- Makes business decisions independently, such as hiring employees or purchasing inventory and supplies.
- Registers as a separate business with other regulatory agencies, such as an agency issuing business licenses, the Employment Development Department, and/or the Secretary of State.
- Deposits funds into a separate account.

In cases where a retailer is not operating as a concessionaire, the prime retailer is *not* liable for any tax liabilities of the retailer operating on his or her premises. However, if a retailer is deemed to be operating as a concessionaire, the prime retailer may be held jointly and severally liable for any sales and use taxes imposed on unreported retail sales made by the concessionaire while operating as a concessionaire. Such a prime retailer will be relieved of his or her obligation for sales and use tax liabilities incurred by such a concessionaire for the period in which the concessionaire holds a permit for the location of the prime retailer or in cases where the prime retailer obtains and retains a written statement that is taken in good faith in which the concessionaire affirms that he or she holds a seller's permit for that location with the Board. The following essential elements must be included in the statement in order to relieve the prime retailer of his or her liability for any unreported tax liabilities incurred by the concessionaire:

- The permit number of the concessionaire
- The location for which the permit is issued (must show the concessionaire's location within the perimeter of the prime retailer's location)
- Signature of the concessionaire
- Date

While any statement, taken timely, in good faith and containing all of these essential elements will relieve a prime retailer of his or her liability for the unreported sales or use taxes of a concessionaire, a suggested format of an acceptable statement is provided as Appendix A to this regulation. While not required, it is suggested that the statement from the concessionaire contain language to clarify which party will be responsible for reporting and remitting the sales and/or use tax due on his or her retail sales.

In instances where the lessor, or grantor of permission to occupy space, is not a retailer himself or herself, he or she is not liable for any sales or use taxes owed by his or her lessee or grantee. In instances where an independent retailer leases space from another retailer, or occupies space by virtue of the granting of permission by another retailer, but does not operate his or her business within the perimeter of the lessor's or grantor's own retail business, such an independent retailer is not a concessionaire within the meaning of this regulation. In this case, the lessor or grantor is not liable for any sales or use taxes owed by the lessee or grantee.

(e) AGENTS. If agents make sales on behalf of a principal and do not have a fixed place of business, but travel from house to house or from town to town, it is unnecessary that a permit be obtained for each agent if the principal obtains a permit for each place of business located in California. If, however, the principal does not obtain a permit for each place of business located in California, it is necessary for each agent to obtain a permit.

(f) INACTIVE PERMITS. A permit shall be held only by persons actively engaging in or conducting a business as a seller of tangible personal property. Any person not so engaged shall forthwith surrender his or her permit to the Board for cancellation. The Board may revoke the permit of a person found to be not actively engaged in or conducting a business as a seller of tangible personal property.

Upon discontinuing or transferring a business, a permit holder shall promptly notify the Board and deliver his or her permit to the Board for cancellation. To be acceptable, the notice of transfer or discontinuance of a business must be received in one of the following ways:

(1) Oral or written statement to a Board office or authorized representative, accompanied by delivery of the permit, or followed by delivery of the permit upon actual cessation of the business. The permit need not be delivered to the Board, if lost, destroyed or is unavailable for some other acceptable reason, but notice of cessation of business must be given.

(2) Receipt of the transferee or business successor's application for a seller's permit may serve to put the Board on notice of the transferor's cessation of business.

Notice to another state agency of a transfer or cessation of business does not in itself constitute notice to the Board.

Unless the permit holder who transfers the business notifies the Board of the transfer, or delivers the permit to the Board for cancellation, he or she will be liable for taxes, interest and penalties (excluding penalties for fraud or intent to evade the tax) incurred by his or her transferee who with the permit holder's actual or constructive knowledge uses the permit in any way; e.g., by displaying the permit in transferee's place of business, issuing any resale certificates showing the number of the permit thereon, or filing returns in the name of the permit holder or his or her business name and under his or her permit number. Except in the case where, after the transfer, 80 percent or more of the real or ultimate ownership of the business transferred is held by the predecessor, the liability shall be limited to the quarter in which the business is transferred, and the three subsequent quarters.

Stockholders, bondholders, partners, or other persons holding an ownership interest in a corporation or other entity shall be regarded as having the "real or ultimate ownership" of the property of the corporation or other entity.

(g) DUE DATE OF RETURNS - CLOSEOUT OF ACCOUNT ON YEARLY REPORTING BASIS. Where a person authorized to file tax returns on a yearly basis transfers the business to another person or discontinues it before the end of the yearly period, a closing return shall be filed with the Board on or before the last day of the month following the close of the calendar quarter in which the business was transferred or discontinued.

(h) BUYING COMPANIES - GENERAL.

(1) DEFINITION**.** For the purpose of this regulation, a buying company is a legal entity that is separate from another legal entity that owns, controls, or is otherwise related to, the buying company and which has been created for the purpose of performing administrative functions, including acquiring goods and services, for the other entity. It is presumed that the buying company is formed for the operational reasons of the entity which owns or controls it or to which it is otherwise related. A buying company formed, however, for the purpose of purchasing tangible personal property ex-tax for resale to the entity which owns or controls it or to which it is otherwise related in order to re-direct local sales tax from the location(s) of the vendor(s) to the location of the buying company shall not be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall not be issued a seller's permit. Sales of tangible personal property to third parties will be regarded as having been made by the entity owning, controlling, or otherwise related to the buying company. A buying company that is not formed for the purpose of so re-directing local sales tax shall be recognized as a separate legal entity from the related company on whose behalf it acts for purposes of issuing it a seller's permit. Such a buying company shall be issued a seller's permit and shall be regarded as the seller of tangible personal property it sells or leases.

(2) ELEMENTS**.** A buying company is formed for the purpose of re-directing local sales tax if it fails to:

(A) Add a markup to its cost of goods sold in an amount sufficient to cover its operating and overhead expenses.

(B) Issue an invoice to the customer, in paper or electronic form, to document the transaction.

(C) Maintain a separate identity with respect to the use of employees, accounting systems (including accounting for cash receipts and disbursements), facilities, and equipment.

(3) MUNICIPAL PURCHASING CORPORATIONS. A buying company formed by, owned or controlled by, or otherwise legally related to, a city, city and county, county, or redevelopment agency, which purchases tangible personal property ex tax solely for resale to such city, city and county, county, or redevelopment agency, shall not be recognized as a separate legal entity from the related city, city and county, county, or redevelopment agency which created it for purposes of issuing the buying company a seller's permit. Such buying company shall not be issued a

seller's permit. The tangible personal property purchased by a buying company from the vendor(s) shall be regarded as having been purchased from the vendor(s) directly by the city, city and county, county, or redevelopment agency related to the buying company.

(i) WEB SITES. The location of a computer server on which a web site resides may not be issued a seller's permit for sales tax purposes except when the retailer has a proprietary interest in the server and the activities at that location otherwise qualify for a seller's permit under this regulation.

Appendix A

Certification of Permit – Concessionaires

I certify that I operate an independent business at the premises of the following retailer and that I hold a valid seller's permit to operate at this location, as noted below. I further understand that I will be solely responsible for reporting all sales that I make on those premises and remitting all applicable sales and use taxes due to the Board of Equalization:

Name of retailer on whose premises I operate my business: _____

Location of premises: _____

_____

I hereby certify that the foregoing information is accurate and true to the best of my knowledge:

Certifier's Signature: _____ Date _____

Certifier's Printed Name _____

Certifier's Seller's Permit Number _____

Certifier's Business Name and Address* _____

_____

_____

_____

Certifier's Telephone Number _____

*** Please Note**: The certifier *must* be registered to do business at the location of the retailer upon whose premises he or she is making retail sales.